1994

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Source: Back Forty

Citation: 4 BACK FORTY 1 (Mar./Apr. 1994).

Title: *Below-Market Interest on Loans and Installment Sales: Tax Consequences*

The BackForty

THE NEWSLETTER OF LAND CONSERVATION LAW

March/April 1994 Vol. 4, No. 4

Below-Market Interest on Loans and Installment Sales: Tax Consequences

by William T. Hutton

Land trusts frequently seek low-cost financing to support acquisitions of property. A no-interest loan from a benefactor may permit the optioning of property ultimately to be sold to a government agency, for example. Or an installment sale, with a below-market interest rate on the deferred payments, may offer the seller an opportunity to make the land trust's acquisition affordable. Yet such transactions demand an understanding of the "imputed interest" rules, a fearsome complex of statutes that has claimed as many innocent victims as the Bermuda Triangle.

This note is intended to provide a working knowledge of the relevant imputed interest statutes.

Loans

Land trusts often secure financial support (or bridge financing) on a no-interest or low-interest basis. A lender who agrees to make such a loan is often surprised to learn that she is not entitled to a charitable contribution deduction for Federal or state income tax purposes.[1]

In order to understand why an income tax deduction would be inappropriate, consider the situation of Bounce Maringo, who makes a one-year, no-interest $100,000 loan to the Hardscrabble Land Trust on January 1. The value of that extension of credit is readily ascertainable, with reference to the going rate for the use of money (i.e., interest). If the appropriate interest rate for loans of that duration and risk is 6%, Bounce has, in effect, made a loan to Hardscrabble of $94,260, and a gift of the value of the use of that amount, interest-free, for one year ($5,740).[2] To establish that the value of Bounce's loan to Hardscrabble is indeed $5,740 at the time the loan is made, consider that Hardscrabble could assure itself of the resources to repay the loan at maturity by placing $94,260 in an interest-bearing account or security yielding a 6% return. Given that possibility, the "extra" $5,740 can be appreciated as an unrestricted gift when the loan is made.

We realize, then, that the interest-free loan is really two quite different transactions rolled into one—a loan and a donation. That being the case, it is bound to seem puzzling, initially, that Bounce is not entitled to a charitable deduction. The reason for the denial of the deduction is that Bounce has not been subject to tax on the imputed income his loan actually produces. Recall that the *real* loan amount is $94,260, and that Bounce will be entitled to receive $100,000 at maturity. The difference is, of course, the equivalent of interest, yet so long as Bounce's loan does not exceed $250,000, he will not be required to report that interest as income. The

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result is a "wash"—the denial of the charitable deduction but the exclusion from taxable income of a precisely matching amount of actual economic income.

If this seems puzzling (as it almost certainly will upon first confrontation), consider the situation of Bounce's sister, Zelda, who makes a 6% *interest-bearing* loan to Hardscrabble of $94,260 on December 31. When the loan becomes due a year later, Zelda receives Hardscrabble's check for $100,000 and then decides, as was her persisting intention, to make a gift to Hardscrabble of the interest element --$5,740. She does so by writing a check to Hardscrabble for that amount. The overall transaction will have no impact on Zelda's tax liability, since her charitable deduction for the cash gift will exactly offset the interest earned on the loan. You will readily appreciate that Zelda and brother Bounce are in exactly the same after-tax position, although that result was reached, in Bounce's case, by the short-circuit process of eliminating both the imputed interest income and the charitable contribution deduction.[3]

Loans in Excess of $250,000

Where the loan balance at any time during a taxable year exceeds $250,000, the lender will not be entitled to the simplicity of the short-circuit approach described above, and both the imputed interest and charitable deduction must be computed. Suppose, to extend the example above, that Bounce advances $300,000 to Hardscrabble on a no-interest basis for one year. The imputed interest required to be added to income would be $18,000, and the imputed charitable contribution would be the same amount, thus washing out the interest income, provided that Bounce is fully able to use the charitable contribution (i.e., is able currently to deduct that contribution within the allowable charitable contribution percentage limitations). If the one-year loan were to span two taxable years, then the imputed interest and charitable contribution amounts would be allocated between those years in accordance with the number of days in each.

Multi-Year Loans

Based upon the discussion above, it might appear that a lender willing to commit substantial funds to Hardscrabble on a no-interest basis for a period of several years might be able to attain a sizable "up front" charitable deduction. Suppose, for example, that Bounce were willing to make his $300,000 advance a 5-year term loan. The entire advantage of that arrangement to Hardscrabble is immediate. If it places $223,228 in an investment or account which provides a 6% return, compounded semiannually, it will be certain to meet its repayment obligation, and the $76,772 "gift" element is in effect immediately and freely available.

Yet the applicable statute (IRC § 7872(a)) requires a year-by-year calculation. Even though Hardscrabble is assured the advantage of this arrangement for the full five-year term, both the imputed interest income and the charitable contribution must be determined annually, resulting in the same precisely matching annual amounts as in our one-year loan example.

Determination of Interest Rate

For loans not in excess of $250,000, the assumption of an imputed interest rate is of course irrelevant, since no computation of either imputed interest or charitable contribution need be made. For loans in excess of that amount, the interest rate is the "applicable Federal rate," as determined monthly by the Internal Revenue Service. If the loan is a demand loan (i.e., a loan repayable upon the lender's demand—an arrangement not to be favored by Hardscrabble for obvious practical reasons), the applicable Federal rate will fluctuate over the loan period. If the loan is a term loan, as in our 5-year loan example above, the rate will be determined as of the date the loan is made.

Loans with Below-Market Interest

If a loan to Hardscrabble bears interest at less than the applicable Federal rate, then the principles discussed above will be applied, but only with respect to the "foregone interest." Thus, on a loan of $250,000 or less, there will be no reporting required. For a loan in excess of $250,000, the annual imputation of interest income and charitable deduction will be reduced by the amount of actual interest payable on the loan and properly allocable to the year of the computation.

Installment Sales

An "installment sale" is a disposition of property where at least one payment is to be received after the close of the taxable year in which the sale occurs. The purchase price is generally a fixed amount, and the deferred payments bear interest, although, as we shall see, that interest may be stated, imputed, or both stated and imputed. As a practical matter, it rarely if ever makes sense to structure an installment sale transaction in which the interest is not at least equal to the applicable Federal rate.

Avoiding Imputed Interest—the Applicable Federal Rate

In order to avoid the imputation of statutory interest on an installment sale—a phenomenon conceptually identical to the imputation of interest on no-interest or below-market-rate loans—it is necessary to provide interest on installment sale payments in an amount not less than the "applicable Federal rate" (AFR). The AFR's are published monthly by the IRS, and the length of the installment payout determines whether reference is made to the "Federal short-term rate" (not over three years), the "Federal mid-term rate" (over three years but not over nine years), or the Federal long-term rate (over nine years). Within those categories, the required interest rates are further refined with reference to the frequency of installment sale payments. To illustrate, the following are the AFR's for March 1994:

	Period for Compounding			
	Annual	Semiannual	Quarterly	Monthly
	Short-Term			
AFR	4.01%	3.97%	3.95%	3.94%
	Mid-Term			
AFR	5.36%	5.29%	5.26%	5.23%
	Long-Term			
AFR	6.35%	6.25%	6.20%	6.17%

In determining the required AFR, the parties to an installment sale may look not only to the rates published for the month of the transaction, but to the published rates for either of the two preceding months. Thus a transaction to be closed in March 1994 may provide interest based on the lowest AFR's published for January, February, or March.

Suppose that Selena McGriff owns undeveloped land with a basis of $240,000 and a fair market value of $600,000, as established by appraisal. She proposes to make a bargain sale to Hardscrabble of that property for $450,000, payable $50,000 at closing and $50,000, plus interest, on each anniversary date of the transaction for the next eight years. If the transaction closes in March 1994, and the installment sale contract is drafted to meet the AFR requirements for that month, interest at 5.36% paid on the outstanding balance of the contract at each anniversary date will satisfy the statute (mid-term rate, annual payments) and no additional interest will be imputed. The overall results of Selena's sale will be a $150,000 charitable contribution (required to be established, of course, by qualified appraisal), a capital gain of $270,000 ($450,000 less allocated basis of $180,000) reported ratably on each payment of principal ($30,000 per payment, including the down payment), and interest each year on the outstanding balance of the installment obligation at 5.36%. On the first of the eight annual payments, Selena would receive a $50,000 payment of principal, of which $30,000 would be long-term capital gain, and an interest payment of $21,440 (5.36% of $400,000). The consequences in the succeeding years would be identical as to the principal payment, but interest would of course be paid only with respect to the declining balance on the note.

Now, for the sake of comparison, let us suppose that Selena agrees to sell her property to Hardscrabble on the same installment-sale basis, but that the contract either fails to provide for interest, or specifically recites that "no interest is to be paid" on the installments. Under those circumstances, Section 1274 of the Internal Revenue Code essentially rewrites the installment contract, creating a substantial interest element on the assumption that each deferred payment bears interest at the applicable Federal rate, compounded semiannually.

Quantifying the application of the imputed-interest rules in our example requires determination of the present value of each deferred payment. For this purpose, the first three payments are discounted at the Federal short-term rate, and the last five payments at the Federal mid-term rate. Calculation of the present value of each principal payment yields the following:

Year of Payment	Present Value of Payment
1995	$48,068
1996	46,210
1997	44,425
1998	40,560
1999	38,493
2000	36,531
2001	34,669
2002	32,902
	321,857

The difference between the aggregate present values ($321,857) and the stated aggregate principal amount ($400,000) is imputed interest, and the tax consequences will be determined accordingly.

Thus, the sale price, stated at $450,000, will be reduced by $78,143 to $371,857; the charitable contribution will increase by the same amount, and Selena will report the imputed interest in accordance with the rules applicable to original issue discount on debt obligations (essentially, by allocating to each year in the installment payment period a portion of the total unstated interest corresponding to the interest economically accrued on the obligation in each such year).[4]

Exceptions

The statute provides certain exceptions to the operation of Section 1274, for:

(1) Sale of a farm at a price that cannot exceed $1,000,000;

(2) Sale of a principal residence; and

(3) A sale involving total payments of not more than $250,000.

If a transaction falls within one of these exceptions, total unstated interest must nonetheless be computed, but the original issue discount rules do not apply. Under Section 483 of the Code, the seller takes the interest into account when paid, if a cash-basis taxpayer. Further, under Section 483 any payment made within six months of the date of the sale is not taken into consideration for purposes of determining total unstated interest.

Conclusion

The tax statutes applicable to the time-value aspects of loans and installment sales represent little more, at bottom, than Congress's rather recent awareness that a dollar today is worth more than a dollar tomorrow. The complexities of the time-value rules are immense indeed, but the basic message for the project negotiator is simple enough: If you don't recognize that deferred payments must bear an adequate interest charge, and provide accordingly, the law will rewrite your deal.

ENDNOTES

1. This assumes a loan of $250,000 or less. Treasury Reg. § 1.7872-5T(b)(9). For loans in excess of that amount, the donor will be entitled to a charitable contribution deduction for the foregone interest, but that deduction will (generally) be matched by an imputed-interest income inclusion of equal amount.

2. The calculation assumes semiannual compounding. See IRC § 7872(f)(2).

3. It may appear that Zelda's charitable contribution is larger than Bounce's ($6,090 v. $5,740), but they are in fact equal, as measured by *present value*, since Bounce's gift is made a year earlier. The discounted value of $6,090, at 6% compounded semiannually, is $5,740.

4. Both the determination of total unstated interest and the treatment of such interest as original issue discount evoke complicated calculations. The point here is to understand conceptually that the use of money, whether borrowed directly or advanced by the seller in the context of an installment sale, involves an interest charge. And if the parties do not make that charge explicit and adequate, the statute, through a process that may involve mind-numbing complications, will so provide.

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